Is an ESOP Right for My Business?

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The number of employee stock ownership plans (ESOPs) has increased considerably since ESOPs were formally established as qualified retirement plans (think 401(k) plan) in 1974. Today, there are approximately 6,500 active plans in the United States with 14.0 million participants.

As the most common structure for broad-based employee ownership, ESOPs are found in publicly-traded and closely-held companies of every size and across every industry. It is no surprise why this retirement plan has gained popularity among business owners, management, and employees. For shareholders, ESOPs are a valuable liquidity mechanism that minimizes business disruptions compared to other forms of ownership transition. For employees and management, ESOP participation is a reward for years of dedication and hard work as well as an incentive for future business growth. Moreover, the benefits of ESOP ownership can be accomplished in a tax-advantaged manner.

What is an ESOP?

ESOPs allow employees to become beneficial owners of stock in the company for which they work. ESOPs are defined contribution plans that primarily invest in employer stock and are governed by the Employee Retirement Income Security Act (ERISA) of 1974. Since that initial legislation, Congress has passed several laws to encourage business owners to establish ESOPs. The intent of Congress is to create ownership and retirement assets for working-class Americans, an effort which has proven highly successful for close to 50 years.

ESOPs are trusts that acquire, hold, and potentially sell the company's stock for the benefit of the participants in the ESOP, namely the employees. Typically, the company borrows money from lenders, investors, and/or selling shareholders and then loans funds to the ESOP trust for the purpose of acquiring shares. As the ESOP loan is paid down, shares are allocated to employee accounts, generally in proportion to an employee's annual compensation. Employees ultimately receive cash in exchange for their shares upon retirement, termination, disability, or death.

An Exit Strategy

Today, many private business owners use employee ownership as their exit strategy. ESOPs are an excellent tool for succession planning, both for liquidity and transition. In addition to various tax benefits, ESOPs also allow business owners to reward their employees and managers with a stake in the business while maintaining independence and preserving the company's legacy.

Flexible

An ESOP transaction can be structured to allow owners to withdraw capital slowly over time or all at once, depending on the specifics of the situation. Owners can sell any amount of their stock to a newly created ESOP. Many owners remain active in the business even after selling all or most of the company to an ESOP.

In addition to flexible timing, the ESOP transaction process offers superior confidentiality relative to third-party sales. The private ESOP transaction does not require confidential information to be shared with prospective buyers (other than the professionals working on behalf of the ESOP), which could have a significant adverse effect on the business. While transaction terms and conditions are negotiated to ensure fairness to the ESOP and its participants, it is widely recognized that an ESOP transaction is far more likely to close.

Continuity

Members of management retain their positions when an ESOP is formed, allowing for a straightforward change in ownership. A smooth transition is critical as management's ability to maintain and grow the business is necessary to create the cash flow needed to pay off acquisition debt. Another advantage of an efficient ESOP transaction is that long-term supplier, distributor, and customer relationships remain uninterrupted. While other exit strategies can have a negative impact on company culture, the transition to employee ownership ensures company culture remains intact or even strengthens as there is better alignment for the interests of management and employees.

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Contrary to popular belief, employee ownership does not mean employees become more involved in day-to-day operations, governance, or strategic direction. There is no requirement to provide employees with financial or strategic information. However, ESOP participants are provided an ESOP summary plan description and annual statements of their ESOP account. In certain situations, employees may be granted voting rights which are specified in the plan document for the particular ESOP company; however, this is atypical.

Employee Benefits

Being part of an ESOP company offers unique rewards for employees. Participants in the plan can receive significant retirement benefits with no direct monetary investment. Research shows ESOP companies are:

- more productive
- faster growing
- more profitable
- have lower turnover

These benefits accrue to all stakeholders including the retirement accounts of the employee-owners. In addition, an ESOP is a great way to enhance the company's ability to recruit and retain top talent. Effective and ongoing employee communications to encourage employees to think and act like owners is necessary in order to optimize these benefits.

Tax Advantages

The tax advantages associated with ESOPs can be significant for the selling shareholders and for the company. For the selling shareholders, the most significant tax benefit can only be realized if the ESOP is purchasing shares from a C corporation through the utilization of section 1042 of the Internal Revenue Code, known as a "1042 rollover." In this circumstance (assuming the ESOP owns more than 30 percent of the outstanding shares post-transaction), the selling shareholders have the ability to roll the proceeds from the sale of their shares into other investments tax free. This "rollover" serves as a deferral of capital gains taxes, allowing the shareholder to defer paying these taxes until ultimate liquidation of the rollover investment assets. However, there are limitations on rollover investments and the advice of seasoned tax and investment professionals is critical to this strategy's success.

The greater tax advantage is to the company. For all companies, payments, in the form of contributions, made to the ESOP are tax deductible.

- In the case of a leveraged ESOP, contributions are made to the ESOP to satisfy the debt incurred as part of the transaction. This means both the principal and interest payments made to the note holder provide a tax deduction to the corporation.

Furthermore, because the ESOP is a tax-exempt trust, the earnings attributable to the ESOP-owned shares are not taxable if the ESOP holds shares in an S corporation. The ESOP must receive its portion of any tax distributions made to satisfy the tax obligations of any non-ESOP shareholders. However, the ESOP gets to keep its portion of the tax distribution to satisfy debt payments or to repurchase participant shares. In addition to forgoing tax distributions, the company is exempt from paying federal and, in most instances, state income taxes if the ESOP owns 100 percent of the S corporation shares. Therefore, the cash is retained in the company to reinvest. Over time, this enhanced cash flow can provide a company with a significant competitive advantage, allowing for:

- accelerated reduction of debt
- greater capital investment or acquisitions
- and enhanced employee benefits

While there are many considerations a business owner must take into account before choosing to sell a business to an ESOP, it is safe to say the tax advantages and associated enhancement of cash flow of an ESOP-owned company are compelling.

Disadvantages

Although the advantages of ESOPs are numerous, it is important to understand that employee ownership is not suited for every company or situation. Good candidates for an ESOP have strong management teams and generally produce consistent and predictable financial results, particularly cash flow. In addition, ESOPs fit best with selling shareholders interested in preserving the legacy of the company and rewarding management and employees with ownership. While ESOPs can pay a competitive price to the selling shareholders, the ESOP cannot pay a strategic premium for the shares it acquires. Rather, the share price an ESOP can offer is limited to the fair market value of those shares. Accordingly, this price may be lower than what could be paid by a strategic buyer. However, tax advantages created in ESOP transactions, along with certain transaction structuring options, can minimize the difference in net proceeds received by selling shareholders.

Once an ESOP is established, proper administration of the plan includes third party administration, valuation, trustee, and legal costs. Business owners and management should be made aware of ongoing plan costs in the feasibility phase of ESOP planning. If the cash flow dedicated to the ESOP will greatly limit the cash available to reinvest in the business over the long term, an ESOP is unlikely to be a good fit.

Long-term planning for the sustainability of the company and ESOP is one of the most important considerations when implementing an ESOP. The company has an obligation to repurchase vested shares from ESOP participants who terminate employment. Therefore, careful cash flow planning must consider the funds necessary to meet ESOP repurchase obligations. Without adequate planning, repurchase obligations can compete with other capital needs, potentially limiting the growth of the company.

ESOPs only provide benefits to the participants if the underlying shares are determined to have value. Therefore, good management and operation of the business is critical to creating a successful ESOP company. The failure of an ESOP company can result in the employees losing their jobs as well as any value that may have accrued in their ESOP accounts. For this reason, it is widely recommended that companies offer retirement benefits in addition to the ESOP. A large percentage of companies that have an ESOP also maintain a 401(k) or profit-sharing plan.

Conclusion

The benefits of employee ownership can be significant for selling shareholders, the management team, and the employees. It is critical to consult with advisors who are knowledgeable about the legal, accounting, and administrative issues unique to ESOPs. Establishing and administering an ESOP can be intricate; however the resulting equitable distribution of wealth can be a key contributor to a company's success. With an ongoing focus on educating participants and guidance from seasoned professionals, the benefits of an ESOP normally far outweigh the complexities.

A seasoned assessment of your company's situation will help you see more clearly. Making the next right decision is your challenge. Helping you do so is our mission. ■